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C O N F I D E N T I A L SECTION 01 OF 03 TEL AVIV 002230

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E.O. 12958: DECL: 06/08/2016

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SUBJECT: PASSAGE OF 2006 BUDGET PRESAGES EXCEEDING LGA
LIMITS IN 2007

Classified By: Economic Counselor William Weinstein for reasons 1.4 b a
nd d.

Summary

11. (C) After a six month delay, the 2006 Israeli budget, the largest ever at NIS 271 billion (USD 60 billion), passed the Knesset on June 7 by a vote of 53 for, 25 against, and 45 abstaining. A considerable amount of expensive last-minute financial maneuvering was needed to secure the abstention of several opposition parties. Meanwhile, numerous Labor Party MKs voted for the budget very reluctantly because they felt it did not adequately address the social welfare issues that were the centerpiece of Labor's election campaign. Many Laborites felt that keeping the increase in expenditures over those of 2005 to one percent was unnecessarily harsh in the present positive economic climate, and were especially perturbed that the budget was cut by about NIS 1.4 billion (USD 311 million) to reach the one percent expenditure growth objective. At a meeting on June 6 with the Deputy Economic Counselor, Ministry of Finance (MoF) Deputy Budget Director Yossi Gordon said that the price paid by PM Olmert to get Labor Leader Peretz to agree to the one percent increase for 2006 was to raise the rate to 1.7 percent in 2007 and beyond as promised in the coalition agreement, breaking the framework of the one percent figure agreed to in the 2003 U.S.-Israel Loan Guarantee Agreement (LGA). Gordon explained that Israel had proactively changed other aspects of the agreement in the past, and said that the U.S. had always been very understanding and flexible regarding such Israeli actions. He painted a very rosy picture of Israel's economic and budget situation and predicted that the budget deficit for 2006 would be close to zero. Disengagement expenses are lower than expected and financial support for PM Olmert's unilateral "realignment" in the West Bank does not even appear in the 2006 budget. End Summary.

Defense Budget Takes a Hit

12. (C) Gordon said that the process of arriving at a final budget had been very difficult. It involved many bitter disputes between the Finance Ministry, which wanted to maintain fiscal restraint, and those in the GOI who cited Israel's recent strong economy -- as evidenced by the first-quarter 2006 growth rate of 6.6% -- to argue for large increases in spending. The NIS 1.4 billion cut to the 2006 budget was an especially bitter blow to those who were looking to take advantage of good economic times to increase spending on social welfare programs. When asked why the budget had to be cut during this period of growth, Gordon said that many annoyed cabinet ministers had asked him the same question. He said that the cut was needed to fulfill Israel's commitment to the U.S. as part of the LGA to keep its year-to-year expenditure increases down to one percent. As a consequence, the Defense Ministry, which had escaped previous budget reductions, was cut by NIS 500 million (USD 111 million), to an overall 2006 budget of about NIS 42 billion (USD 9.3 billion). Another NIS 500 million came from cutting the "discretionary" budgets for the rest of the ministries with the exception of health, education, and welfare by another NIS 500 million, and NIS 400 million was taken out of reserves. The NIS 1 billion spending reductions at the ministries are permanent and will not be restored in future years. Gordon added that there is still "a lot of fat" in the Defense budget. He said that his ministry would push for a NIS 2 billion defense cut in 2007, but would be satisfied with another NIS 500 million reduction.

Busting the LGA Budget Framework in 2007

13. (C) The hit to the Defense Ministry budget was particularly problematic for Labor Chairman Peretz. As the new DefMin, he had pledged to safeguard his ministry's budget. At the same time, however, as his Party's standard bearer, his demand to reduce the defense budget in order to

finance increased social welfare spending had been the centerpiece of his election campaign. To assuage Peretz, PM Olmert agreed to discard the budget framework agreed to with the U.S. and to increase year-on-year spending from 2007 to 2009 by 1.7 percent. With regard to this, Gordon noted that Peretz had been insisting on a two percent figure for 2006, and three or four percent for 2007 and beyond. However, after it was explained to him that Israel was obligated to the U.S. to maintain the one percent rate, he agreed to it for 2006, but insisted on a 1.7 percent rate to at least match Israel's population growth rate for 2007 and beyond, to which Olmert agreed in the coalition guidelines. When questioned as to why the LGA limit applies for 2006, but not beyond, Gordon said that Israel, in the past, has proactively changed or adjusted other aspects of the terms of the LGA, and that the U.S. has always been flexible and shown understanding regarding such Israeli actions. He said that the prevailing Israeli presumption is that the U.S. will show similar understanding in this case. He went on to note that the LGA terms restricting Israel to a deficit of three percent and an expenditure growth rate of one percent were not originally suggested by the U.S., but were rather requested by Israel's Ministry of Finance for use as a tool to ensure a GOI policy of fiscal restraint. In light of that and the economy's present strength, the GOI felt justified in adjusting the expenditure figure upward. He noted, with obvious satisfaction, that his ministry had indeed frequently used the GOI's obligations to the U.S. in the context of the LGA to keep ministers in line on spending questions since 2003.

14. (C) Gordon then added that 2006 was a special budget year. Half the year went by without a budget because of unique political circumstances. Despite the bitterness of the budget fight, people expect the discussions over the 2007 budget to be even more acrimonious and were already positioning themselves for the battles to come. In addition, several more quarters of solid growth in the five percent range are expected, and will make it more difficult than ever to argue for continued adherence to a policy of extreme fiscal restraint. Gordon indicated that while Peretz agreed to the 1.7 percent figure for 2007, he and his party are not happy with it, and will doubtless push for much more when the budget negotiations begin later this year.

Goodies For The Opposition

15. (C) The passage of the budget -- Israel's largest ever at NIS 271 billion -- was marked by a great deal of last-minute maneuvering to ensure a comfortable margin of victory in the Knesset vote. In the face of the unrest among Labor Knesset members regarding the budget's treatment of social welfare issues, PM Olmert reached a series of agreements with opposition parties who agreed to abstain rather than vote against in return for financial compensation. Yisrael Beiteinu (YB), the largely Russian immigrant party headed by Avigdor Lieberman, received about NIS 180 million (USD 40 million) for pet projects such as road safety. The National Union-National Religious Party (NU-NRP) Alliance received NIS 122 million (USD 27 million) and United Torah Judaism (UTJ) NIS 290 million (USD 64 million), to be used largely to support religious institutions.

16. (C) Gordon commented that PM Olmert had made a "strategic decision" to keep these parties from voting against the budget. He said that the amounts involved are smaller than they appear since some of the allotted money was slated to be spent anyway. For instance, of the NIS 180 million for YB, the PM had already decided to spend about NIS 100 million for transportation and road safety projects championed by Lieberman. Of the NIS 122 million allotted for spending on NU-NRP projects, NIS 72 million had already been committed. Therefore, only about NIS 152 million of the NIS 302 million committed to projects supported by YB and NU-NRP actually represented new monies.

UTJ Wants In - But At A Stiff Price

17. (C) Regarding the NIS 290 million for UTJ projects which was announced several hours after the meeting, Gordon said that UTJ Knesset Finance Committee Chairman Yehuda Litzman was being extremely cooperative in helping the government move the budget process forward, even though, as a member of an opposition party, he would doubtless vote against the budget. When asked why Litzman was being so cooperative, Gordon responded that UTJ is still very interested in joining the coalition, but that its entry price is quite high. Cooperation on the budget was a way to keep the negotiating process alive. On child allowances, he noted that the coalition agreement with Shas had not reversed the reductions instituted by the 2003 Netanyahu reforms, but had frozen them at their present levels, instead of having them be reduced

even further over the next three years, as originally planned. UTJ's price for joining the coalition was the reintroduction of the "large family bonus," which would reward families with more than four children and further erode the impact of the Netanyahu reforms.

2006 Deficit Could Approach Zero

18. (C) Gordon said that lower-than-expected spending of NIS 4 billion and higher-than-expected revenues of NIS 5 billion resulted in a NIS 9 billion surplus for the first five months of 2006 (about two percent of GDP). He expected that by the end of the year, about 97-99 percent of the budget allotted for 2006 will have been spent. This is because until the budget was passed, spending in 2006 was based on the lower 2005 budget figure, with a small adjustment for inflation. Spending will rise in the coming months, but will not completely make up for the lower spending from January through May. It is still too early to know by how much the budget will be underspent, but Gordon emphasized that the deficit would be considerably smaller than the originally anticipated NIS 16 billion, and might even approach zero. He noted that this is another reflection of the excellent economic situation in the country and thereby another factor contributing to the argument for increasing year-over-year spending by more than one percent.

Disengagement Cheaper Than Expected,
Realignment Not Yet On Budget Horizon

19. (C) Regarding disengagement expenses, Gordon said that the GOI has so far spent about NIS 5 billion overall for 2005/2006. He said that he expects another billion to be spent in 2007, and possibly another billion or so spread out over the following years, for a total much smaller than many of the original estimates. He illustrated the difficulty of estimating the timing of the expenses associated with withdrawal and compensation by noting that the GOI is still spending money on the early 1980s withdrawal from Yamit in the Sinai Peninsula, in the context of the peace agreement with Egypt. Accordingly he expects disengagement expenses to remain part of the budget picture for years to come. Regarding "realignment," he said that it is not even on the horizon from a budget standpoint, and the 2006 budget contains no mention of it. He said that the 2007 budget might contain a small sum for use towards the end of the year.

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JONES